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Lower House Passes Austere FY 1986 Budget

On March 8 Japan's House of Representatives passed a Y54.1 trillion ($300.5 billion at Y180=$1.00) budget for FY 1986 (April 1, 1986-March 31, 1987). Although the bill, supported by the Liberal Democratic Party-New Liberal Club coalition, was sent to the House of Councillors for debate, the budget will take effect April 7 even without upper house approval.

The budget passed by the lower house is virtually identical to the one ratified by the cabinet last December (see JEI Report No. 1B, January 10, 1986). Total spending is set to rise 3 percent in nominal terms, somewhat less than the 3.7 percent increase in FY 1985's initial budget. The increase is primarily due to a 5.1 percent rise in transfers to local governments and a

10.7 percent increase in debt service costs (see Table). Interest payments on Japan's national debt as a share of government expenditures will exceed 20 percent for the first time. This compares to a 14.4 percent share in the United States in FY 1985 (October 1984-September 1985).

Highlights of Japan's Proposed FY 1986 Budget

(initial budgets in billions of yen)

	FY 1985	FY 1986	Change
Total General Budget Expenditures	Y52,499.6	Y54,088.6	3.0%
Discretionary Expenditures	32,585.4	32,584.2	-0.0
Fiscal Investment and Loan Program	20,858.0	22,155.1	6.2
National Bond Issues	11,680.0	10,946.0	-6.3
Deficit Bonds	5,730.0	5,246.0	-8.4
Construction Bonds	5,950.0	5,700.0	-4.4
Refinancing Bonds	8,960.0	11,492.4	28.3
General Account Expenditures			
Interest on Government Debt	10,224.2	11,319.5	10.7
Transfers to Local Governments	9,690.1	10,185.0	5.1
Social Welfare	9,576.6	9,834.6	2.7
Public Works	6,368.9	6,223.3	-2.3
Education, Science and Technology	4,840.9	4,844.5	0.1
Defense	3,137.1	3,343.5	6.6
Energy Measures	628.8	629.7	0.1
Official Development Assistance	581.0	621.7	7.0
Small and Medium Businesses	216.2	205.2	-5.1

As part of Prime Minister Yasuhiro Nakasone's program to end reliance on deficit-financing bonds by FY 1990, discretionary expenditures will be reduced for the fourth consecutive year. Spending on public works, a major source of pump priming, will be cut 2.3 percent, while defense and foreign aid are set to increase 6.6 percent and 7 percent, respectively. The Fiscal Investment and Loan Program, which is funded primarily by the postal savings system, is slated to increase 6.2 percent after declining in FY 1985.

On the revenue side, changes in the tax system are expected to bring in an additional Y341 billion ($1.9 billion). Much of the burden will fall on the business sector, as the carryover of losses from the previous year will be disallowed temporarily and the 1.3 percent corporate income tax surcharge will be continued. Furthermore, there will be a hike in the excise tax on tobacco products. These increased revenues will be partially offset by tax credits designed to stimulate home purchases. The Finance Ministry plans to issue a total of Y22.4 trillion ($124.6 billion) worth of bonds in FY 1986, with slightly over one-half intended to refinance outstanding debt.

Although fiscal policy should have a mild stimulative impact on the economy in FY 1986 in contrast to the year through March 1986, many observers

fear that continued fiscal austerity in the face of the strong yen will slow growth and tax revenues, making it impossible to meet the twin goals of fiscal stability and expanding domestic demand. On the plus side, though, the decline in oil prices and interest rates should give a significant boost to the private sector.

Randall S. Jones

Rising Yen Reduces Corporate Profits

Japanese corporate profits for fiscal 1985 (ending March 31, 1986) will decline for the first time in three years, according to surveys of major firms by private research organizations. The decline is largely a result of the 43 percent appreciation of the yen since the beginning of the current fiscal year, which has reduced the earnings of many major exporters.

The downturn began during the last quarter of 1985, according to a Finance Ministry survey, when corporate profits declined for the first time since 1983's first quarter. The overall 2.2 percent drop from year-earlier levels was concentrated in major export industries, such as steel, where profits fell 74.8 percent. In contrast, the electric power industry, which benefited from lower oil prices, saw profits rise 35.4 percent.

Corporate profits during FY 1985 will decline between 9.2 percent and 10.8 percent, led by a 21 to 25 percent fall in the manufacturing sector, according to surveys by private research institutes. Particularly notable is the expected 30 percent decline in electric machinery, which includes semiconductors. Profits in the nonmanufacturing sector, however, including oil refining and electric power industries, are expected to increase some 9 to 16 percent.

The reluctance of Japanese firms to raise the dollar prices of their exports by the full amount of the yen's appreciation against the dollar has lowered the yen value of exports and reduced earnings. In the last three months of calendar 1985, the yen value of Japan's exports was down 5.2 percent from 1984's fourth quarter total. During the 1978 rise in the yen, in contrast, rapid growth and high inflation in the United States and other industrialized countries enabled Japanese exporters to raise prices by the full amount of the yen's appreciation without sacrificing export volume. With lower rates of inflation and increased competition from other countries, particularly Korea, Japanese firms are now more hesitant to raise prices.

As for profits in FY 1986, the surveys give sharply different results. Waco Research Institute of Economics Inc., for example, reports that profits are expected to decline 6.4 percent, while Nihon Keizai Shimbun expects an 8.3 percent rise. An increase beginning in the second half of FY 1986 appears more plausible for several reasons. The one percentage point fall in interest rates during the past two months and the decline in oil prices will stimulate the economy. The Institute of Energy Economics estimates that the cost of Japan's oil imports will fall almost 50 percent during FY 1986. Furthermore, the cost-cutting measures adopted by Japanese firms in response to the high yen should help restore profit margins.